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Basel-City (Canton of)

*Ratings Detail (As Of 22-Mar-2007)**

Basel-City (Canton of)

Issuer Credit Rating	AA+/Stable/A-1+
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Issuer Credit Ratings History

17-Jan-2006	AA+/Stable/A-1+
20-Oct-2003	AA+/Negative/A-1+
18-Oct-2001	AA+/Stable/A-1+

Default History

None

Population	188,000
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Per Capita GDP	CHF126,000 (2006e)
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Current Government

The government ("Regierungsrat") consists of seven members. It is headed by the President of government ("Regierungspräsident"), which is elected every year. Dr. Eva Herzog, is head of government.

Election Schedule

Last.....Oct. 2004
Next.....Oct. 2008

Major Rating Factors

Strengths:

- Sound budgetary performance with surpluses after capital expenditures
- Wealthy economy with cantonal income or GDP per capita about 2x the Swiss average
- Net contributor to the Swiss fiscal equalization system
- Sophisticated management

Weaknesses:

- Debt burden of 74% of operating revenue
- Low coverage of the pension fund, with underfunding of more than 30% of the canton's operating revenue

Rationale

The ratings on the Swiss Canton of Basel-City are supported by its sound budgetary performance, strong economy, sophisticated management, and contributor position to the Swiss fiscal equalization system. These positive factors are offset by high debt and an underfunded pension fund.

The canton's budgetary performance in 2007 is expected to remain at a good level. In 2006, the canton achieved a favorable operating surplus of 11.9% of operating revenues and a surplus after capital expenditure of 6.0% of total revenues. This level could be maintained in 2007 if the currently good economic development continues.

The canton, a center of the life-science industry, benefits directly from its strong economy, which is somewhat exposed to the chemical and pharmaceutical industry, but has proved very robust over the past few years. We expect GDP growth to continue above the Swiss average.

The canton is a net contributor to the Swiss fiscal equalization system, which will be amended from 2008. According to the latest calculations, Basel-City will not be affected negatively but may gain more expenditure flexibility. The management's measures in recent years have supported the canton's financial performance effectively. A plan to end the pension fund's underfunding is being negotiated and is expected to be approved in 2007.

The ratings on the canton are constrained by Basel-City's direct debt burden, which was 74% of operating revenues at year-end 2006. Although this represents an improvement on previous years, this is somewhat high compared with other Swiss cantons and international peers.

Besides direct debt, the canton's pension fund represents a significant burden, as Basel-City, like most other cantons, guarantees the fund's actuarial funding gap. At year-end 2005, underfunding totaled Swiss franc (CHF) 1.3 billion, 33% of the canton's operating revenue. For year-end 2006, we expect a slight improvement to about 30% of operating revenue. The pension fund is structurally underfinanced, however, and the negotiated reform is urgently required. A compromise was found in 2006, but still needs to be approved by the cantonal parliament. Under the plan, the pension fund would be recapitalized and the burden shared equally between the canton as employer and the employees and retirees. In effect, acceptance of this concept would mean that the canton's burden would be only one-half of the current funding gap. Furthermore, in the long term, the canton's guarantee for the pension fund is intended to be abolished.

Outlook

The stable outlook on the canton reflects Standard & Poor's expectation that the canton's budgetary performance will remain stable and its debt burden will stabilize or decline slightly over the medium term. The canton's management is expected to set appropriate measures to maintain sound performance and, in the near future, to realize the negotiated plan to recapitalize the pension fund.

The rating could be raised if debt (including the pension fund gap) is significantly reduced. The rating would be lowered, however, if the canton recorded deficits and debt increased, although we consider this unlikely.

Comparative Analysis

Like most of its peers, Basel-City benefits from its economic and financial strength above the national average. Like the Canton of Aargau (AA+/Positive/A-1+), it has a favorable budgetary performance, significantly better than that of the higher rated Canton of Zurich (AAA/Stable/—). In terms of debt burden (including unfunded pension obligations), it is somewhat weaker than Zurich.

Table 1

Basel-City (Canton of) Peer Comparison 2005						
	Basel-City (Canton of)	Aargau (Canton of)	Barcelona (City of)	Brisbane City Council	Vancouver (City of)	Zurich (Canton of)
Issuer credit rating (at March 22, 2007)	AA+/Stable/A-1+	AA+/Positive/A-1+	AA+/Stable/—	AA+/Stable/A-1+	AA+/Stable/—	AAA/Stable/—
Three-year averages, using actual results only						
Operating balance (% of operating revenues)	6.9	8.1	28.2	18.9	11.9	2.6
Balance after capital expenditures (% of total revenues)	1.6	1.7	0.3	1.5	3.3	(4.3)
Capital expenditures (% of total expenditures)	7.5	11.5	31.3	24.3	15.5	11.1
Transfers received (% of total revenues)	9.5	21.4	38.9	N.A.	3.2	26.2
2005 (mil. CHF)						
Total revenues	3,992.7	3,316.2	3,458.2	1,243.0	1,086.9	10,009.0
Modifiable revenues (% of operating revenues)	90.2	77.0	61.2	N.A.	95.1	72.2
Direct debt (at year-end)	3,452.9	1,836.5	2,035.3	821.6	483.9	7,094.9
Direct debt (% of operating revenues)	88.3	58.4	60.8	71.2	49.7	74.5
Tax supported debt (% of total revenues)	86.5	55.4	59.8	66.1	44.5	82.1
Interest (% of operating revenues)	3.0	2.2	3.9	5.0	2.9	2.9
Debt service (% of total revenues)	18.7	15.9	9.3	7.9	5.3	12.4
Free cash & equivalents (% of debt service)	118.3	170.1	111.1	102.0	960.8	226.7

Table 1

Basel-City (Canton of) Peer Comparison 2005 (cont. 'd)						
	<i>Basel-City (Canton of)</i>	<i>Aargau (Canton of)</i>	<i>Barcelona (City of)</i>	<i>Brisbane City Council</i>	<i>Vancouver (City of)</i>	<i>Zurich (Canton of)</i>
Population	187,493	573,654	1,593,000	957,000*	568,440*	1,272,590
Unemployment rate (%)	4.1	3.3	7.0	N.A.	5.7	4.0
GDP (nominal) per capita, unscaled	N.A.	N.A.	37,727.6*	N.A.	N.A.	N.A.
GDP per capita (% of national average)	200.0	N.A.	0.0*	N.A.	N.A.	N.A.
GDP (real) growth (%)	2.6	N.A.	3.3	N.A.	2.9¶	(0.4)*
Total revenues (% of GDP)	N.A.	N.A.	1,784.3¶	N.A.	N.A.	N.A.

*Figures for 2004. ¶Figures for 2003. N.A.—Not available. CHF—Swiss franc.

System Support And Predictability

Net contributor to fiscal equalization system

Switzerland has a financial equalization system with vertical and horizontal components, which redistributes revenues from the financially stronger and wealthier cantons to the financially weaker ones, thereby compensating for the varying levels of financial and economic strength among the 26 cantons. Based on specific parameters, an index of financial strength is derived for each canton. In addition to revenue equalization (“direct equalization”), the federal government participates proportionally in certain expenditure items (“indirect equalization”).

The index of financial strength is recalculated every two years, which redefines contributors to and beneficiaries of the equalization scheme. The index from fall 2005, which is valid for 2006-2007, is 173 for Basel-City (the Swiss average is 100), representing an increase from 166 in the previous period. Basel-City still ranks second of the 26 cantons in the index.

Implementation of reformed equalization system from 2008

The underlying principles of the Swiss cantonal equalization system were renegotiated, as the current scheme is considered to: insufficiently reduce the disparities between the cantons; set wrong incentives, as parts of it are expenditure based (indirect equalization); and be too complex. The new system will be based on tax potential rather than tax revenues, allowing for more flexibility and higher expenditure efficiency for cantons. The new equalization system, which will come into effect from 2008, will result in increased equalization compared with the current system. According to the latest calculations from 2006 and the management’s own expectations, this will only have minor financial effects on Basel-City. The new equalization regime is, however, expected to bring more flexibility to each of the Swiss cantons. Under the new system, the collaboration between cantons will be more formalized and incentives will be set.

Collaboration with the neighboring canton Basel-Country (AAA/Stable/A-1+) will be made easier under the new system. The cantons intend to coordinate health and hospital planning, education (university and colleges), infrastructure (public transport, airport, and river harbors), and cultural affairs.

Economy

The canton's economy is integrated into the Swiss economy nationally and internationally into the "metrobasel" region, consisting of nearly one million inhabitants in the surrounding Swiss cantons, a German county, and three French municipalities. The "metrobasel" project aims to promote and strengthen the region across its political and national borders.

The canton benefits from excellent access to national and international traffic, as it is a gateway to Germany and France for road, rail, air, and Rhine river shipping.

Its economically strong position shapes the region's attractiveness and perspectives. The well-known pharmaceutical companies Novartis AG (AAA/Stable/A-1+) and Roche Holding AG (AA+/Stable/A-1+) have their headquarters in Basel-City.

In 2008, Switzerland will join the Schengen convention. This allows the liberalization of border traffic, and is expected to be beneficial to cantons near national boundaries, such as Basel-City.

Basel-City consists of the City of Basel and two small municipalities. The canton's budget includes that of the City of Basel (cantonal and municipal level).

Urban population characteristics

The canton's population has been declining since peaking at the end of the 1960s. Over the past five years, Basel-City's population has stabilized at about 188,000 inhabitants. Over the next decade, only a very slight decline is expected.

The canton's population is significantly older than the Swiss average, which is typical for a Swiss city. In recent years, the canton could benefit from inward migration of working-age population from other cantons but mainly from abroad, which has helped maintain a sound population structure.

Very high wealth

Basel-City's cantonal income or GDP per capita was about 2x the national average in 2006, helped by the high number of companies and jobs, which attract commuters from outside the canton. In 2006, nominal GDP per capita is expected to have been CHF126,000, not only 2x the Swiss average, but also more than 3x the EU average.

Basel-City's economic performance is expected to have grown favorably to about 4.1%, well above the Swiss average of 2.7% in 2006. In 2007, only slightly weaker growth rates of about 3.0% are expected for Basel-City. Under a realistic economic scenario, growth rates of 3.0% in the coming years could be maintained. This would mean ongoing growth above the national average.

The chemical and pharmaceutical industry accounts for a dominant nearly 40% of gross value added in Basel-City. This industry is focused on pharmaceutical products and life sciences, which are activities with high value-added and favorable growth perspectives. For the canton, this is the main economic growth driver. That specific industry, for example, grows 5%-6% each year.

The financial sector is the second dominant sector in Basel-City. Some Swiss banks are based in the canton and the international bank UBS AG (AA+/Stable/A-1+) maintains its second headquarters in the city. Furthermore, the international organization, the Bank for International Settlements is based in the canton.

Very low unemployment

Basel-City's unemployment in 2006 has been 3.7%, significantly lower than 4.1% in 2005. The canton's unemployment is slightly above the Swiss average, however, which was 3.3% in 2006. Compared with neighboring regions in Germany and France, these rates are favorable. The canton's labor market is very attractive, competitive, and flexible. Some deregulation in recent years has eased access for migrants and commuters from abroad.

Management Capacity And Institutional Legitimacy

Consensus-based democracy

The cantonal parliament ("Grosser Rat") consists of 130 members and is elected every four years. Eight parties are represented, with a left-oriented majority. The canton's parliament historically maintains stability and consensus in its sessions and decisions. The cantonal parliament has, in particular, to approve annual budgets and annual accounts. The government ("Regierungsrat") is also directly elected. The current government consists of seven members, each heading a department of cantonal administration. Dr. Eva Herzog is the head of the financial department responsible for cantonal taxes and financial accounts.

The canton management's priorities are:

- Sound economic development;
- Urban development;
- Strengthening regional cooperation;
- Sustainable fiscal policy; and
- Elimination of the pension fund's coverage gap.

The canton's financial reporting is comprehensive and transparent. It does not, however, include a consolidated view including all associated companies. The canton's medium-term planning is very conservative and only discloses a general view on aggregated expenditure and revenue items. Several compulsory or facultative referenda and initiatives on cantonal or federal matters are held each year.

Financial Flexibility

Above-average tax and public-service level

The canton has its own tax code and therefore full legislative power over cantonal taxes. Unlike most other cantons, however, Basel-City's tax multiplier is subject to a facultative referendum, which could constrain its tax-raising flexibility.

Tax rates in Basel-City are relatively high by Swiss standards. In 2005, the tax index for individuals (108.6%, compared with the Swiss average of 100.0%) was the fifteenth highest in the country, but for corporate taxes it was third highest (124.3%). The overall tax index ranking for Basel-City is 13th highest at 112.1%. For Basel-City, however, the above-average tax level is not a

restraining factor. As demonstrated in the past, the canton is well able to attract companies to invest or expand their business activities. The canton maintains higher levels of public services and infrastructure, which supports its attractiveness to investors and individuals. Furthermore, the canton owns several financial assets (utility companies, a public sector bank, and real estate) that provide additional revenue flexibility, as they could be sold in case of need. The canton had financial assets of CHF2.2 billion in 2005. Some of these could easily be converted into cash.

Tight expenditure control

In recent years, the cantonal government has successfully implemented several measures to keep expenditures under control. Further similar steps are not planned, but could be considered if necessary. The main expenditure drivers in past years have been social and health care. Capital expenditures are maintained at appropriate levels, but could easily be postponed, as infrastructure is of a high standard.

The cantonal budget includes the municipal funds for the City of Basel, which therefore provides it with greater flexibility on expenditure and revenue than other Swiss cantons.

Budgetary Performance

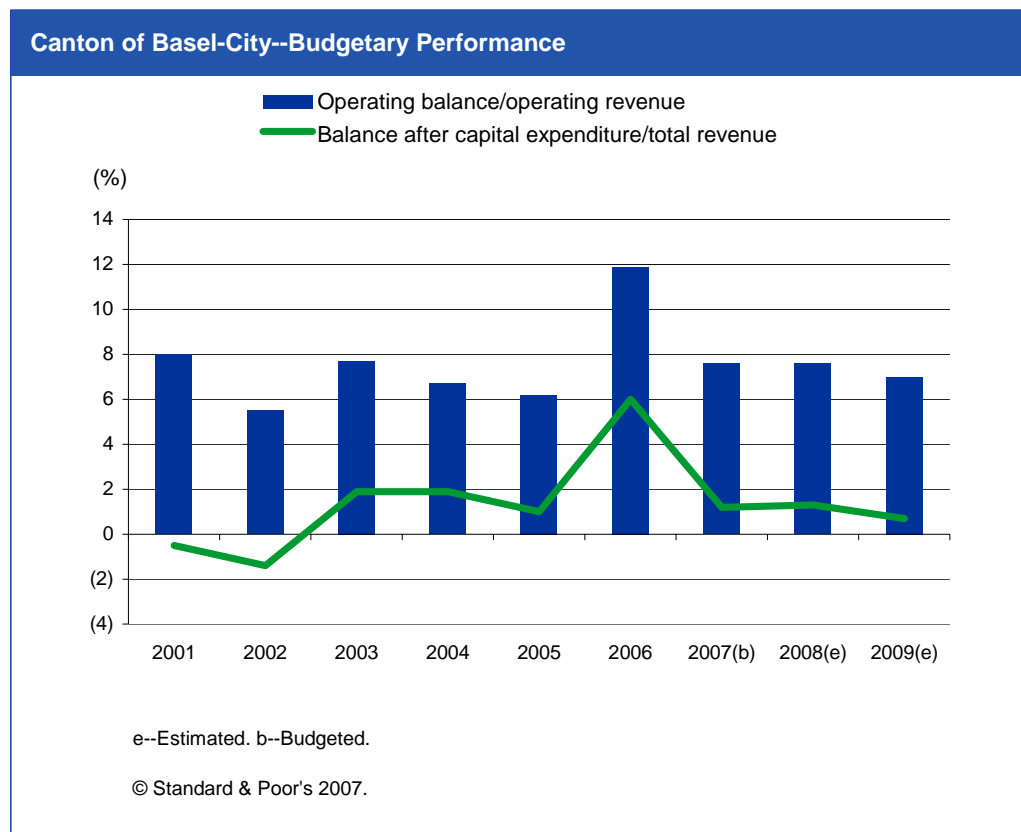
Basel-City's 2006 budgetary performance outperformed the budgeted figures and achieved an operating surplus of 11.9% of operating revenue and a surplus after capital spending of 6.0% of total revenue. This was the best financial result for many years.

This favorable result is driven by the economically good development boosting corporate tax payments. Expenditure control measures taken in recent years further support the upward trend of cantonal financial performance. The very dynamic growth of some social and health expenditures in recent years has appeared to slow significantly. Social benefits, for example, that showed double-digit growth in recent years, are stabilizing in 2006. In the long term, although high, corporate tax revenues are quite volatile, which is accounted for in conservative budgeting by the cantonal management.

The 2007 budget provides for a further positive performance. The budget plan describes an operating surplus at 7.6% of operating revenue, and surplus after capital spending is budgeted at 1.2% of total revenues. As in the past, the canton budgets conservatively and we expect it to be easily achievable given good economic development.

The canton's medium-term financial planning to 2010 projects a slight weakening of budgetary performance. We expect results to be only slightly weaker than levels of 2006 and 2007 (see Chart 1). Should economic development slow, however, the canton will have to take appropriate measures to avoid deficits in its budgets.

Chart 1



Liquidity And Debt Management

The canton has quick and easy access to liquidity in the markets. At year-end 2006, liquid assets amounted to more than 100% of debt maturing in the next 12 months.

Financial assets (cash and equivalents) totaled CHF515 million or 15% of operating expenditures at year-end 2006.

Debt management is very sophisticated. The canton has asset-liability guidelines in place that should support continued low financing costs and adequate liquidity.

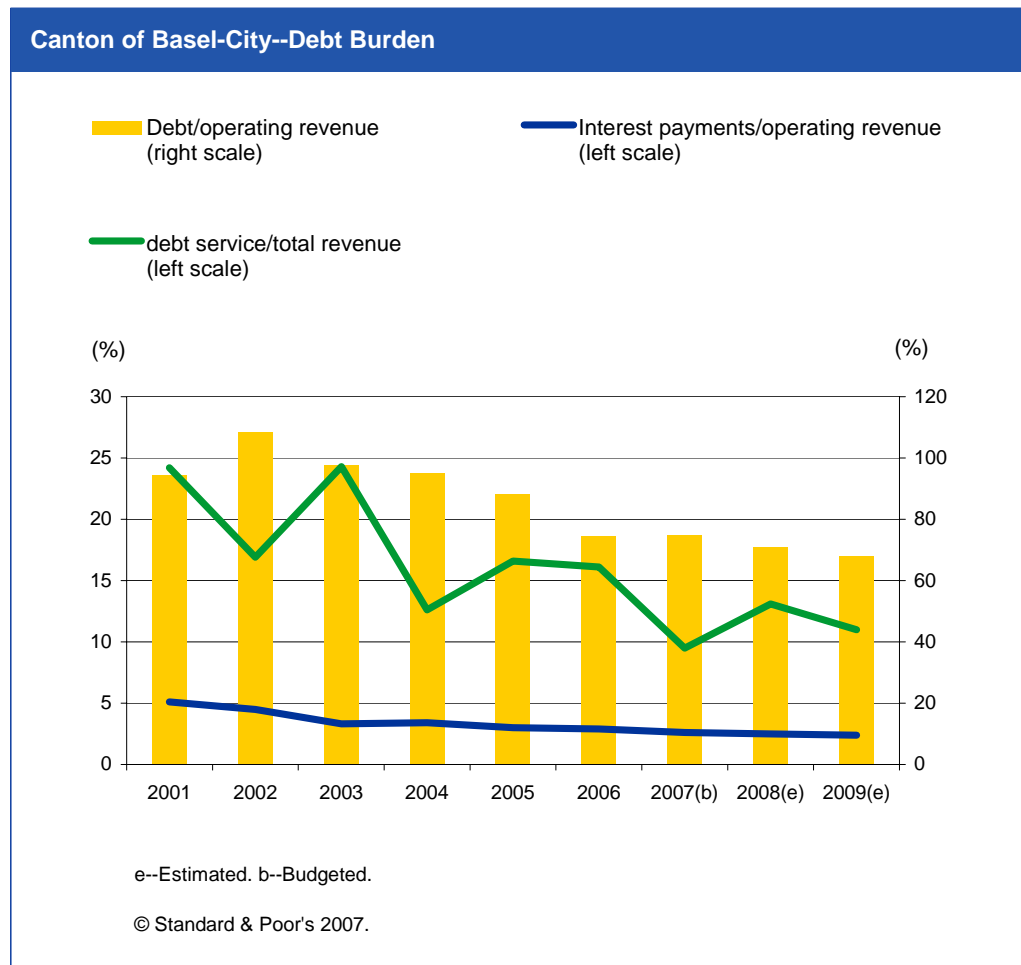
In 2006, debt service was 15.9% of total revenues. Interest payments account for 2.9% of operating revenues.

Debt Burden

Direct debt

Basel-City's debt burden was 74.4% of operating revenues at year-end 2006, after 88% in 2005 (see Chart 2). The significant decline in debt was achieved through the use of cash received in 2005 from the sale of the Swiss National Bank's gold. In the coming years, we expect the canton to reduce its debt burden slightly by reducing some of its liquidity and achieving surpluses. Nevertheless, this does not take into account any transaction with regard to the recapitalization of the pension fund, as described below.

Chart 2



Pension fund recapitalization

Basel-City formally guarantees the pension fund’s actuarial underfunding. Negative asset performance at the beginning of the decade has resulted in a substantial drop in the funds coverage rate, which in the meantime has improved to 78% at year-end 2005. The funding gap therefore amounted to CHF1.3 billion, 33% of the canton’s annual operating revenue.

At year-end 2006, we expect a further reduction of the funding gap due to good asset performance in 2006. Structurally however, the pension fund is underfinanced, and a reform is urgently necessary. The canton’s management has acknowledged this and carried out negotiations with all stakeholders and parties. In 2006, a compromise appears to have been found, although it still requires approval by parliament. The plan to recapitalize the pension fund aims to share the burden equally between the canton as employer and the employees and retirees. The plan requires 30 years to abolish structural imbalances. During these years, the canton will have to make additional payments, and the employees and retirees will accept certain modifications of the pension scheme. In effect, acceptance of this plan would mean that the canton’s burden is only one-half its present size.

The implementation of the proposed plan requires several steps. At first, the canton would completely recapitalize the pension fund by borrowing money and injecting it into the fund. Over

the following 30 years, this loan will be repaid by the canton, supported by lower benefit schemes. When the loan is amortized, the canton would abolish its guarantee to the fund, as it will be redundant.

Contingent Liabilities

The canton's largest contingent liability is Basler Kantonalbank. In addition to the capital stock already brought into the bank, the canton is legally required to guarantee all its liabilities. Further contingent liabilities stem from legally required guarantees and accounted for less than 1% of operating revenues in 2005. Besides Basler Kantonalbank, Basel-City has several interests in public and private companies (transport, higher education institutions, and hospitals).

Table 2

Basel-City (Canton of) Financial Statistics

	—Year ended Dec. 31—									
<i>(Mil. CHF)</i>	2009(e)	2008(e)	2007(b)	2006	2006(b)	2005	2004	2003	2002	
Operating revenues	3,947.0	3,897.0	3,818.6	3,979.8	3,795.5	3,911.2	3,764.6	3,759.0	3,658.8	
Operating expenditures	3,670.0	3,600.0	3,530.0	3,507.1	3,577.9	3,670.0	3,511.6	3,469.0	3,457.2	
Operating balance	277.0	297.0	288.6	472.6	217.6	241.2	253.0	290.0	201.6	
Operating balance (% of operating revenues)	7.0	7.6	7.6	11.9	5.7	6.2	6.7	7.7	5.5	
Capital revenues	60.0	60.0	60.5	81.1	70.5	81.5	79.2	98.7	79.7	
Capital expenditures (capex)	309.0	306.0	303.9	309.9	332.2	281.3	258.6	316.6	334.9	
Balance after capex	28.0	51.0	45.2	243.8	(44.1)	41.4	73.6	72.1	(53.6)	
Balance after capex (% of total revenues)	0.7	1.3	1.2	6.0	(1.1)	1.0	1.9	1.9	(1.4)	
Debt repaid	440.0	520.0	270.0	540.0	530.0	629.0	355.0	814.0	467.0	
Net budget loans	N.A.	N.A.	N.A.	2.1	0.0	(26.6)	(12.0)	18.6	(53.1)	
Balance after debt repayment and onlending	(412.0)	(469.0)	(224.8)	(294.1)	(574.1)	(561.1)	(269.4)	(760.5)	(467.5)	
Balance after debt repayment and onlending (% of total revenues)	(10.3)	(11.9)	(5.8)	(7.2)	(14.9)	(14.1)	(7.0)	(19.7)	(12.5)	
Gross borrowings	362.0	419.0	174.0	60.0	360.0	497.0	196.0	500.0	N.A.	
Balance after borrowings	(50.0)	(50.0)	(50.8)	(234.1)	(214.1)	(64.1)	(73.4)	(260.5)	(467.5)	
Balance after borrowings (% of total revenues)	(1.3)	(1.3)	(1.3)	(5.8)	(5.5)	(1.6)	(1.9)	(6.8)	(12.5)	
Modifiable revenues (% of operating revenues)	90.0	89.9	89.7	89.9	90.0	90.2	89.9	90.7	88.9	
Capex (% of total expenditures)	7.8	7.8	7.9	8.1	8.5	7.1	6.9	8.4	8.8	
Operating-revenue growth (%)	1.3	2.1	(4.4)	1.8	(3.0)	3.9	0.2	2.7	(5.5)	
Operating-expenditure growth (%)	1.9	2.0	(1.3)	(4.4)	(2.5)	4.5	1.2	0.3	(2.9)	
Direct debt (debt outstanding at year-end)	2,684.0	2,762.0	2,863.0	2,959.6	2,921.0	3,452.9	3,583.4	3,668.6	3,965.5	
Direct debt (% of operating revenues)	68.0	70.9	75.0	74.4	77.0	88.3	95.2	97.6	108.4	
Interest (% of operating revenues)	2.4	2.5	2.6	2.9	3.0	3.0	3.4	3.3	4.5	
Debt service (% of total revenues)	11.0	13.1	9.5	16.1	16.6	18.7	12.6	24.3	16.9	
Cash plus committed facilities (% of operating expenditures)	9.5	11.1	12.8	14.7	8.4	20.3	9.0	10.9	19.0	
Cash (% of debt service)	79.6	76.9	166.7	95.3	56.6	118.3	88.9	46.2	140.6	

b—Budgeted. e—Estimated by Standard & Poor's. N.A.—Not available. CHF—Swiss franc.

Table 3

Basel-City (Canton of) Economic Statistics						
	2006	2005	2004	2003	2002	2001
Population	N.A.	187,493	186,753	188,213	188,015	187,459
Population growth (%)	N.A.	0.4	(0.8)	0.1	0.3	(0.6)
Unemployment (%)	3.7	4.1	4.6	4.3	3.0	2.2

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